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Role of microcredit and microfinance in the eradication of poverty

Report of the Secretary-General

Summary

The present report is submitted in response to General Assembly resolution 61/214. The report provides a reassessment of the role of microcredit and microfinance in the eradication of poverty based on recent studies. The report also describes the latest developments in microfinance, including the emergence of new providers. In conclusion, the report presents some recommendations, including the promotion of inclusive financial institutions.

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Contents

		Paragraphs	*Page*
I.	Introduction	1–4	3
II.	Microfinance penetration and client demand	5–14	4
	A. Population penetration	5–8	4
	B. Understanding the demand for microfinance	9–11	5
	C. Emerging clients	12–14	6
III.	Impact of microcredit and microfinance on the welfare of the poor	15–28	6
	A. Income and employment	15–18	6
	B. Consumption smoothing and microinsurance	19–20	7
	C. Impact on poor women and empowerment	21–26	8
	D. Social performance audits	27–28	9
IV.	Developments among microfinance providers	29–60	9
	A. Growth and transformation of microfinance institutions	29–34	9
	B. Commercialization of microfinance	35–38	12
	C. Increased competition	39–40	13
	D. Innovations in microfinance	41–44	14
	E. Impact of technology	45–46	15
	F. Challenges faced by microfinance providers	47–50	15
	G. Challenges for policymakers and regulatory authorities	51–54	16
	H. The vision for inclusive finance	55–60	17
V.	Conclusion	61–67	18

I. Introduction

1. Microfinance is broadly defined as the provision of financial services such as credit, savings, insurance and other basic financial products involving very small (micro) amounts to poor and low-income people who normally lack access to traditional banking and financial services. Microfinance originated with microcredit, which is the provision of credit in small amounts to very poor people, often without requirements for collateral. Microcredit is considered to have been pioneered by Muhammad Yunus in Bangladesh. He noted that poor women had no access to formal financial services because they could not post collateral and were considered to be high credit-risk borrowers. Instead of requiring collateral, Muhammad Yunus experimented with "group lending", where credit was extended based on a group liability arrangement. Although the loan was granted to an individual, the repayment was a collective responsibility by the group to which the individual belonged. The high repayment rates on their loans paved the way for the success of what was to become the Grameen Bank. The Grameen Bank is one of the earliest known formal institutions created to extend microcredit. From its origins in the mid-1970s, its membership had grown to 1 million by 1991, 2.4 million by 2002 and 6.9 million in 2006.[1] Together with the Grameen Bank, early pioneers of microcredit include ACCION International, which provided the impetus for the growth of microcredit in Latin America, and the Self-Employed Women's Association Bank in India.

2. The successes of the microcredit pioneer organizations have led to a worldwide expansion in microcredit. As the financial services offered by these organizations expanded beyond providing credit to include taking deposits, savings accounts, microinsurance and money transfers, the term "microfinance" was coined to reflect this evolution. The Monterrey Consensus,[2] adopted by heads of State and Government at the International Conference on Financing for Development in 2002, explicitly recognized that microfinance and credit for micro-, small- and medium-sized enterprises, as well as national savings schemes, are important for enhancing the social and economic impact of the financial sector. By its resolution 53/197, the General Assembly designated 2005 as the International Year of Microcredit to address the constraints that exclude people from full participation in the financial sector. A major outcome of the Year — publication of the "Blue Book" *Building Inclusive Financial Sectors for Development*[3] — provides a framework to guide national policies in providing access to affordable financial services for all people. In addition, the United Nations Advisers Group on Inclusive Financial Sectors was established to assist stakeholders in identifying ways to expand access to financial services for the poor.

3. In recent years, microfinance has experienced tremendous growth in the number of clients served and the diversity of financial services offered. Along with the growth in clients and in products and services offered, there has also been a large increase in the number of microfinance providers, known as microfinance institutions. The broad definition of these institutions encompasses a wide range of

[1] B. Armendariz and J. Morduch, *The economics of microfinance* (Cambridge, Massachusetts Institute of Technology Press, 2005), p. 6.

[2] *Report of the International Conference on Financing for Development, Monterrey, Mexico, 18-22 March 2002* (United Nations publication, Sales No. E.02.II.A.7), chap. I, resolution 1, annex.

[3] United Nations publication, Sales No. E.06.II.A.3.

organizations, which vary in their legal structure, mission and approach. However, all of them share the common characteristic of providing financial services to poor and socio-economically vulnerable people who would not normally be served by traditional financial institutions. Today, microfinance institutions include non-governmental organizations, credit unions, cooperatives and bank and non-bank financial institutions.

4. Microfinance has gained wide acclaim in helping the poor, especially women, through increased incomes, self-employment and empowerment. There is greater awareness of the positive impact of microfinance on the lives of the poor, but the challenge of scaling up its impact remains. The success of microfinance is due in part to a growing recognition that the poor are viable customers and to the entry of mainstream financial institutions into the microfinance business, which has provided alternative sources of funds for microfinance. By adapting new technologies, microfinance is able to broaden its outreach and reduce costs to both clients and providers. There is growing concern, however, over increasing commercialization and profit-orientation in microfinance. These developments have led to the promotion of a paradigm shift from microfinance to a vision of inclusive finance.

II. Microfinance penetration and client demand

A. Population penetration

5. According to the Microcredit Summit Campaign, 3,316 microcredit institutions provided loans to 133 million clients worldwide in 2006, up from 618 institutions and 13 million clients in 1997.[4] Further disaggregation of data indicates that 92 million of those clients belonged to the bottom half of the people living below their nation's poverty line when they took their first loan.

6. The reach of microfinance varies across different regions of the world. Asia and Latin America have the highest numbers of borrowers, while few benefit from microfinance in the Middle East, Northern Africa and Central Asia. In Latin America, microfinance clients are found mainly in cities, where the highest numbers of poor people live, while the vast majority of clients in Asia are located in rural areas.

7. Altogether, the extent of the penetration of microfinance (defined as the proportion of the poor who are reached by microfinance relative to total population, a commonly used measure in microfinance) remains limited. In countries with the largest availability of microfinance, the penetration is commonly in the range of 3 to 4.5 per cent of the total populations. Penetration is typically much lower in countries with large populations, such as Brazil, India and Nigeria (0.1 per cent), Pakistan (0.3 per cent), Mexico (0.4 per cent) and Indonesia (1.3 per cent).[5] Bangladesh stands out with a penetration rate of 9.2 per cent of the population.

8. While microfinance was originally conceived to target the poor, an in-depth study by the Consultative Group to Assist the Poor of the client base of seven microfinance institutions in Bangladesh, Bolivia, the Philippines and Uganda, found

[4] S. Daley-Harris, *State of the Microcredit Summit Campaign Report 2007*, pp. 2 and 22.

[5] E. Rhyne and M. Otero, "Microfinance through the next decade: visioning the who, what, where, when and how" (Boston, ACCION International, 2006), table 3, p. 12.

that a large majority of microfinance clients were moderately poor (those in the top 50 per cent of households below the poverty line), few were from extremely poor households (those in the bottom 10-50 per cent below the poverty line) and none were destitute (those in the bottom 10 per cent).[6] The study also found that the one provider, BRAC Bangladesh, that had targeted poorer segments of the population was able to reach proportionately more extremely poor households. However, by and large, reaching the extremely poor and destitute remains a challenge for microfinance.

B. Understanding the demand for microfinance

9. Whereas microcredit development has largely been driven by supply, there has been a growing focus over the years on understanding the financial needs of the poor. The knowledge gained about client behaviour has been instrumental in designing new microfinancial products. A study suggests that many poor households are not borrowing because they are averse to incurring debt.[7] Furthermore, it was found that the poorest of the poor were usually net savers and that the most effective way to reach them was by offering savings accounts.

10. Research on microfinance, including client behaviour, has also shed light on when and why clients self-exclude themselves from financial services. In Bangladesh, a study of poor slum-dwellers concluded that this potential client group would avail itself of microfinance services and products if it was given flexibility in meeting the required membership contributions or deposits.[8] The self-exclusion was based on a fear of being unable to meet rigid repayment schedules. As with any consumer group, the poor also prefer to have a choice in the financial services that they seek. Such choice is not available when microfinance institutions have a narrow product offering or have rigid terms and conditions.

11. Insights into the dynamics of group lending have also led to a better understanding of cases where there was a high dropout rate among poorer clients.[9] One explanation put forward is that when the size of a loan taken by other group members rises beyond what individuals perceive they themselves can afford or repay, they become hesitant to guarantee such loans. At the same time, group lending can also have drawbacks for those clients who are better off within a group. These clients face the risk of delays in obtaining larger loans when some group members are in arrears. Some also feel frustrated with the time spent in borrowers' group meetings.

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[6] Brigit Helms, *Access for All: Building Inclusive Financial Services* (Consultative Group to Assist the Poor, World Bank Publications, 2006), p. 20.

[7] D. Johnston and J. Morduch, "Microcredit vs. microsaving: evidence from Indonesia" presentation at the Conference on Access to Finance, World Bank, Washington, D.C., 15 and 16 March 2007.

[8] Consultative Group to Assist the Poor, Focus Note No. 18, "Exploring client preferences in microfinance: some observations from SafeSave", September 2000.

[9] Consultative Group to Assist the Poor, Focus Note No. 16, "Those who leave and those who don't join: insights from East African microfinance institutions", May 2000.

C. Emerging clients

12. Traditionally, although not exclusively, microfinance has targeted poor women, consistent with its early experience of success with women clients and the positive socio-economic consequences of lending to women. Recent developments suggest that this is changing. In reaching more poor people and new clients, there has been less emphasis by newer microfinance institutions on catering mainly to women.

13. One emerging client group for microfinance is young people. The profile of young microborrowers differs from that of the existing microfinance clients, as young clients tend to be highly mobile, urban-based and technologically knowledgeable. Concern has been raised that group lending might not work for this client group, whose needs group could differ from traditional clients. A study in Uganda found that youth needed savings services more than credit and that tailoring financial products to their needs had led to positive results. In addition, young people are more likely to be involved in overseas employment. This has generated demand for remittance services. While this tendency towards mobility may discourage microfinance institutions from lending to the young, mobile banking services and branchless banking are becoming popular among young people and are increasingly being provided by microfinance institutions.

14. Agricultural producers are another emerging group of clients. In contrast to traditional clients, who are often engaged in cottage industries or buy-and-sell businesses, agricultural producers are vulnerable to climatic conditions and need microinsurance to reduce their risk of loss and consequent inability to service microloans.

III. Impact of microcredit and microfinance on the welfare of the poor

A. Income and employment

15. There is ample evidence that access to credit has given many poor people the means to increase, diversify and protect their sources of income to some extent. Microcredit has an impact on the lives of the poor both directly and indirectly. The most direct way is through providing income and opportunities for self-employment. Moreover, microfinance institutions consistently report higher levels of food consumption among their clients. Microloans, particularly to women, also tend to have an indirect impact translating into improved access to health and education for children.

16. Currently no comprehensive quantitative study exists that would give a sense of the actual net effect of microcredit on income and employment. A study of the impact of microcredit schemes in seven countries in Latin America, Asia and Africa showed that, for a large proportion of borrowing households, increase in income stalled or plateaued after initial progress.[10] Lack of entrepreneurial skills and limited demand for the goods and services of microenterprises appear to have been

[10] D. Hulme and P. Mosley, *Finance Against Poverty* (London, Routledge, 1996), vol. I, p. 114. The sample countries were Bangladesh, Bolivia, Indonesia, Kenya, Malawi and Sri Lanka.

responsible for this effect. Evidence from BancoSol of Bolivia, for example, showed that most did not have the entrepreneurial capacity to utilize the loans productively; whereas 25 per cent of clients showed significant income gains after borrowing, 60 to 65 per cent remained at the same level of income and 10 to 15 per cent went bankrupt.[11] As for how significant the increase in income is, an impact assessment study carried out in Ghana found that, on average, clients had increased their incomes by $36, compared to $18 for the control group.[12] Further studies of microfinance institutions in India, Peru and Zimbabwe found that net income gains by borrowers were observed only in India and Peru, suggesting that the hoped-for microfinance income effect was not always realized.[13]

17. While it is equally difficult to obtain comprehensive data on the employment impact of microfinance, case studies anecdotally support the claim. Microcredit has helped to create microenterprises and has enabled microentrepreneurs to generate jobs in the informal sector for others in their communities. Examples in Kenya, South Africa and Uganda show that microfinance provided to the non-poor was instrumental in creating jobs for very poor people as employees of microfinance clients.

18. Overall, microfinance contributes to improve the life and welfare of the poor. However, as a tool for poverty reduction, lifting people out of poverty on a sustainable basis, the data is far less conclusive. A review of the literature on the impact of microfinance sponsored by the Grameen Foundation concludes that despite the effectiveness of microfinance in increasing family incomes and improving children's nutrition and raising the school enrolment rate, it cannot be stated that microfinance works as a poverty reduction strategy on a global basis.[14]

B. Consumption smoothing and microinsurance

19. Several studies have found that microcredit is also being used for consumption smoothing. Consumption smoothing enables the poor and vulnerable to deal with short-term financial difficulties and income disruption arising from medical and health emergencies, natural calamities or death of a family member. This temporary rechannelling of funds turns out to have a real and tangible impact on the lives of the poor, often preventing them from becoming destitute.

20. In order to address the existing demand for protection against income disruption, a number of microfinance institutions now offer microinsurance products. Such products often find their inspiration in traditional forms of risk mitigation. In Benin, Burkina Faso, Mali, Senegal and Togo, for example,

[11] Armendariz and Morduch, op. cit., p. 200, citing P. Mosley, "Metamorphosis from NGO to commercial bank: the case of BancoSol in Bolivia", *Finance Against Poverty*, David Hulme and Paul Mosley, eds. (London, Routledge, 1996).

[12] Barbara MkNelly and Christopher Dunford, "Impact of credit with education on mothers and their young children's nutrition: Lower Pra Rural Bank Credit with Education Program in Ghana", Research Paper No. 4 (Davis, California, Freedom from Hunger, 1998), as reported in Jonathan Morduch and Barbara Haley, "Analysis of the effects of microfinance on poverty reduction", report prepared by RESULTS Canada for the Canadian International Development Agency, November 2001.

[13] Armendariz and Morduch, op. cit., p. 199, citing Snodgrass and Sebstad (2002).

[14] Nathanael Goldberg, *Measuring the Impact of Microfinance: Taking Stock of What We Know* (Grameen Foundation, USA Publication Series, December 2005), p. 46.

microinsurance schemes based on the Islamic insurance concept of *takaful* and operated by cooperatives provide borrowers with coverage for death or permanent disability.

C. Impact on poor women and empowerment

21. The rationale for targeting women within the framework of microfinance is threefold.[15] First, women are overrepresented among the poorest of the poor. Secondly, women clients have high repayment rates on loans. Thirdly, women tend to be more concerned over the health and education of their children.

22. Quantifying the net social benefits of microfinance on poor women remains difficult. The number of women availing of microfinance nonetheless suggests that microfinance makes a difference in their lives and those of their children. All estimates point to women accounting for about 75 to 80 per cent of microfinance clients.[16]

23. As microfinance turned millions of poor women into active participants in economic activities, they attained new roles as income earners and managers of household incomes. As a result, these poor women are found to be more confident, assertive and better equipped to overcome cultural inequalities. Their success raises their status in society, turning them into important role models for the population of young girls who are growing up poor and underprivileged. Studies indicate that the success of these women tend to be associated with effective family planning and better treatment of children, in particular young girls, in terms of nutrition, health and schooling.

24. Some outcomes, however, have an adverse impact on women. This includes increased workloads and exhaustion, as mothers and wives double up their traditional household duties with the demands of their self-employment activities and responsibilities to their microfinance institutions. Cases of loan "pass-through", where women apply for microloans only to turn the funds over to their husbands to be diverted for other purposes, have also been observed.

25. Furthermore, cultural prejudice and obstacles tend to confine women to certain types of economic activity. They are often bound to activities with very low levels of productivity with limited opportunities for innovation or advancing into more lucrative ventures.

26. Increased incomes from microenterprises run by women are often used on health and education. This has led a number of microfinance services, such as those provided by ProMujer in several Latin American countries, to include the provision of health-awareness programmes as part of their services. As a result, higher rates of immunization of children and of use of family planning have been observed among clients compared to non-client counterparts. Some studies also suggest that children of microfinance clients are more likely to go to school, stay in school longer and have lower dropout rates.

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[15] Armendariz and Morduch, op. cit., pp. 179-183.

[16] Ibid.

D. Social performance audits

27. Increased public scrutiny of the effectiveness of microfinance in combating poverty has led microfinance institutions to develop tools for managing their social performance. Social performance audits look at the objectives of the institutions and the services provided to meet those objectives. Performance indicators include loan appreciation criteria, gender constraints, client education, grievance management and the effectiveness of reaching poor households. Microfinance support and rating institutions have developed approaches that integrate social performance indicators into internal management information systems and also offer external auditing.

28. A review of the literature raises questions about the high cost of social performance monitoring in comparison with the limited financial resources of many microfinance institutions. However, some also raise concern that microfinance institutions are only required to report financial performance and thus face a temptation to overemphasize financial self-sufficiency over impact on poverty, and leading them to drift away from their original mission.

IV. Developments among microfinance providers

A. Growth and transformation of microfinance institutions

29. Microfinance has seen significant growth and popularity in the past 30 years, even more so recently. Between 2004 and 2006, institutional and individual investments in microfinance more than doubled to around $4.4 billion, while the total volume of loans has risen to $25 billion, according to Deutsche Bank.[17] In India, it is reported that 1,000 microcredit organizations and some 300 commercial banks lent $1.3 billion to 17.5 million people in 2006. Separately, self-help groups, the dominant microfinance model in India, have provided loans to an estimated 33 million poor Indian households through compulsory savings mechanisms and have showed faster outreach at a lower cost, compared with other traditional models of microfinance.[18] In Bangladesh, the Grameen Bank is reported to have disbursed $4 billion in microloans to 7 million borrowers over the past 10 years.

30. The growth of microfinance has been accompanied by a proliferation of microfinance providers, from solidarity-based organizations and non-governmental organizations to cooperatives and rural banks and, more recently, to commercial banks. In addition, there is a large informal zone of microfinance providers such as postal banks, informal rotating savings and credit associations and commercial players, including moneylenders, pawnbrokers, consumer lenders, retailers and mobile telephone companies.

[17] J. Surowiecki, "What microloans miss", *The New Yorker*, 17 March 2008.

[18] Consultative Group to Assist the Poor, "Sustainability of self-help groups in India: two analyses", Occasional Paper No. 12, August 2007.

Box 1
Self-help groups in India

In India, self-help groups comprising 10 to 20 poor women each are fast becoming the dominant form of microfinance. Self-help groups are community-based and member-managed associations of poor women who pool resources for financial and social services. Aside from pooling financial resources, self-help groups also serve women and their families through the provision of health-care services, such as polio vaccination and family planning information, literacy training, food-for-work opportunities and midday meal programmes.

As at March 2006, there were an estimated 2.2 million self-help groups that provided financial services to around 33 million members. Studies suggest that well-run groups are financially sustainable and experience high repayment rates of around 95 per cent from their members. They are able to reach very poor and marginalized clients. After initial donor funding, self-help groups turn to commercial banks for additional funding. The link between self-help groups and commercial banks is driven by a Government mandate for lending quotas in priority sectors. The programme, which allows self-help groups to borrow from banks to obtain funds for lending among their members, is managed by the National Bank for Agriculture and Rural Development.

Sources: Website of the National Bank for Agriculture and Rural Development (http//nabard.org/pdf/stmt1.pdf) and "Sustainability of self-help groups in India: two analyses", Consultative Group to Assist the Poor, Occasional Paper No. 12, August 2007.

31. As more financial institutions provide financial services to the poor, several pioneer microfinance institutions have experienced significant client growth and expanded their operations. To this end, some not-for-profit microfinance institutions have become mainstream financial institutions or chartered banks. Bolivia's BancoSol, for example, started as a non-profit microlending entity called PRODEM. It later joined with ACCION International and other financial entities to establish BancoSol, which became the first private commercial bank in the world dedicated exclusively to microfinance.

32. In shifting to a chartered microfinance provider, former not-for-profit microfinance institutions are able to access new funding sources such as taking deposits and commercial funding and also have more diversified sources of revenue through more product offerings. The transformation improves their cost structure through economies of scale and enhances sustainability and long-term viability. However, the transformation is also associated with greater profit orientation and a shift away from their original social goals.

33. A recent study, based on a control group of around 25 microfinance institutions, showed that over a five year period, transformed microfinance institutions achieved a higher rate of increase in the number of borrowers (30 per

cent) compared with microfinance institutions that did not change (15 per cent).[19] Furthermore, the transformed microfinance institutions also saw a surge in clients with savings accounts. A disturbing outcome, however, was that transformed institutions had a significant decline in the percentage of women clients, from an average of 88 per cent to 60 per cent. Considering that many microfinance institutions had the traditional goal of serving women who are poor, the question is whether the profit motive overshadows the original social mission of microfinance to serve the poor, resulting in a drift away from their original mission and earning higher returns by serving better-off clients with larger loans.

34. While mission drift is a typical concern in the context of transforming microfinance institutions, there are also instances of transformation where mission drift is not an issue. In the case of the Center for Agriculture and Rural Development Bank in the Philippines, no external funding was needed to make the transition to a formal financial institution. It continued to rely on capitalization from member savings and retained earnings and maintained its commitment to its members.[20] Two issues played an important part in its transformation experience: its original vision and the profile of the board. One of the Center's original visions was to become a formalized institution with women clients as share holders. In addition, the board was committed to fulfilling its social mission. Similarly, MI-BOSPO in Bosnia and Herzegovina also envisioned transformation without compromising its original mission. The transformation of the Kashf Foundation in Pakistan was driven by its inability to raise funds from its client base of mostly women. However, true to its commitment to serving poor women, it introduced savings products suited to its clients. These examples of microfinance institutions show that staying committed to the original clients and mission is possible while undergoing transformation.

Box 2
Initial public offering of Compartamos Banco

A headline-grabbing example of a recent transformation of a microfinance non-governmental organization into a profit-oriented commercial financial institution is that of Compartamos Banco in Mexico. Its initial public offering in April 2007 enabled the original investors to sell part of their investment to the public and take advantage of gains.

Compartamos Banco started as a village banking pilot programme in 1990 to support microenterprises as part of a non-governmental organization. It attained operational self-sufficiency in 1995. In 2000, it separated from the non-governmental organization and became a regulated financial entity, with a $6 million equity investment from the International Finance Corporation, the ACCION Gateway Fund, ProFund International, its founding non-governmental organization and Mexican private investors. It started accessing the capital markets in 2002 by issuing bonds to finance its growth. It formally became Compartamos Banco in 2006 when it obtained a commercial bank licence.

[19] Christina Frank, "Stemming the tide of mission drift: Microfinance transformations and the double bottom line", Women's World Banking, 2008.

[20] Ibid., p. 18.

Since 2000, it has registered annual client growth ranging from 31 per cent to 56 per cent. By 2006, it had about 620,000 clients, almost 10 times the 64,000 clients it had in 2000. Its leaders attribute much of its ability to expand its client size to its commercial nature and the ability to raise funds in the commercial markets.

For the supporters of Compartamos Banco, the initial public offering was viewed as a culmination of the bank's commercialization and a validation of the commercial model of microfinance. For its critics, the offering was another sign of how far the bank had drifted away from its original mission to help the poor. For them, Compartamos Banco was operating for the benefit of its investors rather than for its borrowers, with over 20 per cent of its interest income booked as profits and its average return to equity more than three times the 15 per cent average for Mexican commercial banks.

Sources: ACCION International, "The Banco Compartamos Initial Public Offering", *Insight*, No. 23, June 2007, and Elisabeth Malkin, "Microfinance's success sets off a debate in Mexico", *The New York Times*, 5 April 2008.

B. Commercialization of microfinance

35. An important development in recent years that has raised both interest and concern among stakeholders is how microfinance has drawn the attention of major mainstream financial institutions including commercial and investment banks and other financial institutions. These were the institutions that have long excluded the poor from access to financial services on the notion that the poor are not creditworthy and that servicing the poor is unprofitable. However, the profitability and sustainability of successful microfinance institutions eventually convinced commercial financial institutions that the poor were bankable and that the returns on commercial participation in microfinance were real, given the high interest rates the poor were willing to pay on microloans.

36. Commercial players and investors have found the microfinance sector, albeit small, to be an area that offers much wider credit spreads and returns and promising growth. Some commercial banks have entered the microfinance market directly with programmes aimed at the lower end of the financial services spectrum, while others have entered into alliances and linkages with institutions already focusing on the lower tier of the market.

37. Some of these new commercial entrants include hedge funds, venture capital firms and other big investors, whose participation has introduced new ways of raising funds for microfinance. For example, the Teachers Insurance and Annuity Association — College Retirement Equities Fund, a pension fund for teachers in the United States of America, aims to invest $100 million in microfinance with an eye to competitive returns.[21] It also bought a $43 million stake in a company based in Frankfurt, Germany (ProCredit Holding), which manages microlenders in

[21] Examples cited here are from K. Epstein, "Microfinance draws mega players", *BusinessWeek*, 9 July 2007.

20 countries from Ecuador to Sierra Leone, expecting a 15 per cent return on equity. In another case, Morgan Stanley, a Wall Street investment bank, securitized in early 2007 a portfolio of small loans worth $108 million from a dozen for-profit lenders and offered attractive yields of up to 7.7 per cent to investors. In addition, retail stores have entered the microfinance business. Wal-Mart, a retail giant from the United States which operates over 1,000 stores in Mexico, offers microloans to customers through its on-site Banco Wal-Mart, by capitalizing on a core group of 2.5 million loyal shoppers who do not have bank accounts.[22] The competition with traditional financial institutions is expected to drive down the transaction costs of borrowing.

38. Whereas the new entrants are undoubtedly helping to scale up the provision of microfinance to the poor, there is concern that the commercialization of microfinance would sacrifice the socially responsible lending principles of microfinance institutions and expose borrowers to potentially abusive lenders. The drift away from the non-profit orientation of early microfinance institutions is becoming a trend and has also fuelled a debate over which model is most appropriate to serve the needs of the poor.

C. Increased competition

39. With new entrants coming into the sector, competition among providers has intensified, resulting in lower prices, tighter margins and a broadening of product offerings beyond lending. Furthermore, increased competition has led to more individual-based lending, which is a move away from the traditional group-based lending. Although microfinance institutions relied in the past on group pressure for the repayment of loans, in recent years providers have increasingly relied on collateral for loan repayment guarantees. The microfinance approach (group pressure without collateral) was viewed as cumbersome since it required the organization of groups and greater efforts in coordinating group members. The newer approach, which is standard in the traditional finance sector, offers a faster way of underwriting and providing credit. However, the drawback in collateral-based lending is that it is biased against the poor, who have limited or no collateral, defeating the original reason for adopting group-lending. In addition, those who can borrow are exposed to the risk of losing their only asset in case of default.

40. Furthermore, while the newer approach to lending has enabled faster growth in microlending, providers themselves are becoming concerned that without proper legal control of the provision of collateral, there is the risk that the same collateral could be used to back multiple loans from different competing providers. In sum, competition has both positive and negative effects on clients. On the positive side, clients benefit from broader product offerings at lower cost and better-off borrowers and small enterprise owners may get access to larger loans. On the negative side, collateral-based lending arising from competitive pressures may discriminate against those with little or no collateral.

[22] G. Smith and K. Epstein, "Wal-Mart banks on the 'unbanked'", *BusinessWeek*, 13 December 2007.

D. Innovations in microfinance

41. The global expansion of microfinance has been accompanied by diversification and innovation in the supply of financial services to the poor as well as by increasing reliance on communication technology. Microfinance product offerings now include savings accounts, insurance, money transfers and microleases in addition to microloans. Three major innovations have been introduced that aim at better catering to the latent demand for financial services by the poor: microfinance services for young people; the "graduation model", which links safety nets and financial services, and agricultural microfinance, which merges traditional agricultural finance with standard microfinance schemes.

42. In the Philippines, the lack of commercial banks willing to provide loans to young people inspired the creation of YouthWorks, one of the first microfinance institutions for young people. YouthWorks gives young people access to small start-up loans and microfinance as part of a programme for job placement and skills training.[23] Experience has shown that not only are young people reliable in repaying their loans, but they also invest their loans in enterprises that generate social and environmental benefits. One of these enterprises has created work for about 300 people by making fashion bags and wallets exported to Europe and the United States from recycled tarpaulin used for advertising billboards.

43. The objective of the graduation model is to provide social protection to destitute households and to eventually graduate them out of destitution to a lesser degree of poverty.[24] A pioneering example of a graduation programme is the "income generation for vulnerable groups development" model by BRAC in Bangladesh. The BRAC model enabled two thirds of the destitute women participating in the programme to graduate to regular microfinance programmes. Overall, the model has shown potential in reaching the poor, but also points to the need for longer-term provision of basic social protection. Another successful example is a programme run by CARE Bangladesh where microfinance is linked with Government-guaranteed employment schemes. In this programme, 79 per cent of those who graduate become self-employed in microenterprise activities three years after the end of the programme cycle. Attempts to replicate such an approach, such as in Malawi, have not, however, been successful.

44. Agricultural microfinance, which is traditionally considered to be high risk and characterized by poor repayment rates, is another area of innovation.[25] Agricultural microfinance schemes for poor farmers combine a group lending approach with traditional agricultural finance services such as repayment schedules based on the production cycle and harvest time, equipment leasing and crop and livestock diversified lending, among others. Participants in this microfinance area are both microfinance institutions, such as cooperatives, and non-microfinance institutions adopting microfinance agricultural financing schemes. For example, in Madagascar the Caisses d'épargne et de crédit agricole mutuels (a network of local

[23] S. Murray, "Microfinance: lending where a little can go a long way", *Financial Times*, 24 January 2008.

[24] Examples for this section are taken from Consultative Group to Assist the Poor Focus Note No. 34, "Graduating the poorest into microfinance: linking safety nets and financial services".

[25] This section draws on Consultative Group to Assist the Poor, Occasional Paper No. 11, "Managing risks and designing products for agricultural microfinance: features of an emerging model" (August 2005), pp. 3-5, 20 and 26.

banks and credit unions) provides microleases averaging $450 for capital equipment for agriculture and livestock, with flexible repayment schedules based on the client's production cycle.

E. Impact of technology

45. Information and communications technology, in particular mobile telephone technology, plays an increasing role in promoting the growth of microfinance. The ubiquity of mobile telephones in developing countries, even among the poor, has given a growing number of poor people access to microfinance. In the Philippines, for example, the country's two mobile network operators offer the functional equivalent of small-scale transaction banking to an estimated 5.5 million customers. Similarly, in Kenya, the M-PESA service offered by mobile telephone company Safaricom, which allows individuals to transfer money using a mobile telephone, attracted 1 million registered users in 10 months, in a country where fewer than 4 million people have bank accounts.[26] The potential of mobile banking to reach the poor and those in remote areas is especially promising considering that there are now two billion mobile telephones in use worldwide. While it took 12 years to have the first billion mobile telephones in circulation, it only took two and a half years to reach the second billion, with 82 per cent of the second billion being in developing countries.

46. Branchless banking is another technology-based innovation that is significantly extending the reach of microfinance among both the urban and rural poor. Branchless banking uses outlets such as grocery stores, post offices, pharmacies, lottery dealers, petrol stations and seed and fertilizer retailers equipped with point-of-sale and automatic teller machines able to swipe bank cards and read barcodes. Among the pioneer countries are Brazil, India, Kenya, South Africa and the Philippines. In Brazil, for example, banks have established more than 95,000 banking representatives in 1,600 Brazilian municipalities (a quarter of all municipalities) that had no financial service outlets. In South Africa, WIZZIT provides basic mobile telephone and banking services in tribal and rural areas where there is limited access to banks.[27] In Uganda, a web-based non-profit innovation is the peer-to-peer microloans conceived by the group Kiva. Where the Internet is available, networks allow ordinary people to loan small amounts of money (as little as $25) to needy individuals on flexible loan terms.[28]

F. Challenges faced by microfinance providers

47. Microfinance providers continue to face a number of challenges, including the need to scale up operations, efforts to achieve sustainability without relying on

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[26] Consultative Group to Assist the Poor, Focus Note No. 43, "Regulating transformational branchless banking: mobile phones and other technology to increase access to finance", January 2008.

[27] G. Ivatury, "L'avenir de la microfinance repose sur la technologie", Dossier l'alter-banque, *Revue Banque*, No. 692, June 2007.

[28] Website of the Foundation for P2P Alternatives (http://www.p2pfoundation.net/P2P_Microfinance) accessed on 7 July 2008.

subsidies, obtaining access to funding sources and complying with general rules and regulations of the financial sector.

48. Faced with the challenges of increasing their reach while ensuring the sustainability of their programmes, microfinance providers face pressure to keep costs down and operate more efficiently. Small microfinance institutions, operating with high overhead costs, find it difficult to compete with larger operations where the fixed costs are shared among many more clients and accounts. In addition, some small institutions need to diversify the risks associated with operating in a small geographic area with a limited product offering and client base. Furthermore, most microfinance providers have limited or no access to financial markets.

49. Access to mainstream funding sources by microfinance institutions continues to face several constraints.[29] Many microfinance institutions remain non-profit institutions without a corporate legal status, raising concerns over the legal basis for recovery of defaulted loans. Ratings agencies have inadequate knowledge about microfinance operations and microfinance institutions are therefore perceived as posing higher risks. In addition, commercial banks believe that the portfolios of many microfinance institutions are inadequately secured, which could prompt regulators to impose more rigorous controls. Finally, the more recent approaches to secure new sources of funds, such as securitization and issuance of bonds or notes, will probably suffer given the current credit crunch in the financial markets.

50. Many of the small operators find it hard to generate sufficient revenue with which to cover their lending, invest in technology and pay for professional management and operations staff with a sufficient cushion to absorb the occasional increases in credit losses that arise in periods of economic slowdown. In all cases, microfinance institutions need to tap non-aid sources of funds, whether by offering deposit services or by obtaining wholesale funding from commercial institutions, if they are to grow beyond the limits of finance from aid and subsidies.

G. Challenges for policymakers and regulatory authorities

51. Policymakers and regulatory authorities need to address issues related to subsidies, unethical lending practices, and building an inclusive financial structure, including the formation of credit bureaux, credit-rating services and payment systems across different financial institutions.

52. In its guidelines on good practices in microfinance, the Consultative Group to Assist the Poor recommends that subsidies should support microfinance during the initial period but microfinance institutions should eventually wean their operations away from dependency to sustainability. This recommendation reflects concerns that overdependence on subsidies results in inefficiencies, shirking of responsibilities and rent seeking that eventually undercut the sustainability of microfinance institutions. There is also evidence, however, that subsidies, up to a certain level, can lead to improved efficiency and sustainability.[30] Experience shows that

[29] *Building Inclusive Financial Sectors for Development* (United Nations publication, Sales No. E.06.II.A.3), pp. 78-85.

[30] Marek Hudon and Daniel Traca, "On the efficiency effects of subsidies in microfinance: an empirical inquiry", Université Libre de Bruxelles, Solvay Business School, Centre Emile Bernheim, Working Paper No. 06-020.RS, October 2006.

subsidies have been part of the successful social impact of models that integrate microfinance with social services (see, for example, the description of the graduation programme for vulnerable groups by BRAC in Bangladesh in para. 42 above). Subsidies also help to attract additional funding creating a crowding in rather than a crowding out effect, as conventional wisdom suggests. For example, in the case of the securitization deal between India's ICICI Bank and SHARE Microfin, subsidies enabled receipt of funding from another donor, the Grameen Foundation.[31] It appears that provided subsidies are time-limited and rigorously evaluated they play an important role in microfinance.

53. Microfinance institutions are increasingly faced with the responsibility of developing mechanisms to address unethical lending practices and to protect the vulnerable from the risk of high-yielding "predatory" lending practices. Codes of conduct are also needed to address the risk that fast growth and overexpansion can lead to overindebtedness by the poor and undermine the long-term growth and prospects of microfinance itself.

54. More generally, as part of the larger financial industry microfinance institutions need to contend with the issue of regulation and consumer protection. As microfinance institutions compete with larger commercial financial institutions, they need to face new sets of regulatory standards and requirements. Compliance with such standards and requirements imposes additional resource requirements, which could be very expensive for smaller institutions with many small accounts.

H. The vision for inclusive finance

55. The success of microcredit and microfinance over the years has shown the potential of microfinance institutions to help the poor and contribute to the socio-economic development process. The challenges of microfinance and the lessons learned over many years outline some important direction for the future.

56. Reaching the poorest poor, who have been excluded from microfinance, largely through microcredit, has to be re-evaluated. Since the poor are not an homogeneous group, financial products that meet the diverse financial needs of the poor should be explored (for example, the poorest poor may prefer savings as an alternative form of insurance). Policies to address the challenges related to the transformation and expansion of microfinance institutions should also be assessed.

57. The recognition of the various challenges facing microfinance institutions and the need for States to allocate limited financing resources to help the poor has led to the promotion of inclusive finance as a new paradigm dealing with the financial sector that serves the poor and broader society. This involves adequate financial services for small and medium-sized enterprises and for microenterprises. The outcome document of the International Year of Microfinance 2005 (the "Blue Book" *Building Inclusive Financial Sectors for Development*) states that the rationale behind inclusive finance was that access to a well-functioning financial system can economically and socially empower individuals, in particular poor people, allowing

[31] J. Morduch, "Smart subsidy for sustainable microfinance", Asian Development Bank, *Finance for the Poor*, vol. 6, No. 4, December 2005.

them to better integrate into the economy of their countries, actively contribute to their development and protect themselves against economic shocks.[32]

58. To achieve the vision of inclusive finance, financial services for poor and low-income people should be seen as an important and integral component of the financial sector and various types of financial institution, based on their own comparative advantages, should see them as an emerging business opportunity, and inclusive finance should be part of any financial sector development strategy.[33]

59. The United Nations Advisers Group on Inclusive Finance Sectors works with Governments, regulatory and supervisory bodies, central banks, academia and the private sector to identify and define key issues limiting access to financial services. It advises the United Nations system on strategies and concrete steps to expand access to financial services for all. The Group's key message to Governments is that they need to ensure that inclusive finance is an integral part of any financial sector development strategy and to create a policy environment that can broaden access.[34]

60. Inclusive finance builds on the foundation of microfinance and hopes to enable smaller microfinance institutions to achieve scale and sustainability, while letting a cross-section of financial institutions also meet the needs of the poor and nearly poor through more diverse product and service offerings. Inclusive finance also hopes to provide greater choice and flexibility in terms of transaction size and loan repayment schemes and to be more responsive to the requirements of the poor.

V. Conclusion

61. The review presented in the present report points to both the remarkable contribution of microcredit to alleviating the conditions of well over 100 million people living in poverty worldwide and the need to broaden the institutional capacity, focus and approach of microfinance institutions.

62. The breadth and depth of outreach of microfinance to the poor, while impressive, remains very limited, both locally and globally. Innovations in the provision of microfinance services, awareness of the diversity of the poor and the growing involvement of commercial providers may lead to an increase of the reach to different population groups.

63. However, it has become clear that the current contribution of microfinance lies in improving the lives of the poor, rather than as a pathway out of poverty. Self-employment activities generated by microloans are low-productivity in nature and very rarely lead to the development of small enterprises. To a large extent, the explanation rests on the fact that the poor, in particular the rural poor, live in areas that typically lack economic opportunities. Moreover, most microfinance institutions are not in a position to provide the financial services that small and medium-sized enterprises, as opposed to microenterprises, need.

64. Small and medium-sized enterprise development is critical to the generation of productive employment, which is of central importance to poverty eradication, as

[32] United Nations publication, Sales No. E.06.II.A.3, p. 4.

[33] Ibid., p. 17.

[34] *Microcredit, Microfinance, Inclusive Finance: Building on Success, Recommendations from the Work of the United Nations Advisers Group on Inclusive Financial Sectors*, June 2008.

reaffirmed by the Economic and Social Council in 2008, in its resolution on promoting full employment and decent work for all.

65. Catering to the financial needs of small and medium-sized enterprises should be seen as an extension of the traditional lending rationale. It would, therefore, seem advisable for successful microfinance providers to forge alliances with other providers of financial services in order to build sound, sustainable and inclusive national financial sectors that could cater to the needs of all, from the poorest households to enterprises, and promote business opportunities and productive employment on a significant scale.

66. Governments play an important role in providing an enabling environment conducive to the achievement of an inclusive financial sector that encompasses the poor. The role of Governments has been comprehensively addressed in the "Blue Book" and has been a key area in the work of the United Nations Advisers Group on Inclusive Financial Sectors. The Advisers Group has developed key messages which attempt to distil the key actions that Governments may wish to consider in order to develop inclusive financial sectors that can help to promote poverty reduction.

67. **In this regard, Member States may wish to consider the following recommendations:**

(a) **Establishment of a framework for promoting the development of inclusive financial institutions that offer appropriate financial products and services to all segments of the population, including the poor, and to significantly increase outreach to unserved and underserved enterprises and households;**

(b) **Adoption of a coherent financial regulatory framework, in consultation with microfinance providers, that will effectively protect the stability of the financial system and increase access of the poor and micro- and small enterprises to financial services, while taking into account the different types of microfinance providers and the diverse products and services they offer;**

(c) **Adoption of regulatory standards that protect consumers, in particular the poor, given their limited financial literacy, against predatory and abusive lending practices;**

(d) **Integration of financial and consumer education for the poor as part of the framework to promote awareness of microfinance programmes;**

(e) **Support for the expansion and reach of microfinance through the promotion of entrepreneurship development programmes, including for micro, small and medium-sized enterprises.**